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PART 8 ALTERNATIVE METHODS OF  
MEETING FUTURE REVENUE NEEDS IN MT.


MONTANA TAX STUDY

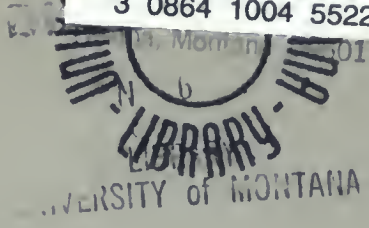
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PART VIII

ALTERNATIVE METHODS OF MEETING FUTURE REVENUE NEEDS IN MONTANA

by

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A staff paper submitted through the Tax Study Task Force to the  
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The title of this part of the Montana Tax Study implies that the revenue needs of the state of Montana will grow through time. This implication is consistent with the historical experience of all state governments and the experience of the Federal Government as well. There seems to be general agreement among laymen and politicians alike that the need for revenue to finance public services will continue to expand. A growing, progressive economy, such as the United States economy and most of the state economies, seems to require an expanded input of public services. It is probably true that expanding public services are a pre-requisite to the growth and progress of an economy structured along mid-20th century lines. A rapidly growing body of literature on investment in human beings indicates that both the social and the private rate of return on investment in people exceeds the rate of return on non-human capital by a wide margin.<sup>1</sup> In particular, the rates of return on investment in health and education appear to be extremely high. Viewed in this light, public expenditure for these purposes should be considered as productive investments that yield high rates of return rather than mere costs.<sup>2</sup>

Prospects for increased needs for public revenue always pose the problem of how the tax system should be structured to provide the revenue. Even though the expenditure of such revenues is productive from both the individual and the social point of view, purchasing power must be transferred from individuals or private economic units to government. This means that, in the first instance, the purchasing power of private economic units must decline. Economically rational individuals usually prefer that their own purchasing power, remain intact, or at least that the taxes necessary to provide needed public services take relatively less from their purchasing power than from others. Because of this selfish although rational nature of man, providing more revenue for public services always boils down to the question how the burden of taxation ought to be distributed.

The principles or criteria for distributing tax burdens have been discussed elsewhere in the Montana Tax Study reports.<sup>3</sup> Such things as ability to pay and benefits received are usually mentioned in this connection. The first of these involves ethics and value judgments more than it involves economics. There is no way that we can measure the sacrifice that one individual undergoes in paying a dollar in taxes as contrasted to another individual. There has been developed in economics, however, a concept known as "diminishing marginal utility of income." Stated in simple form, this concept says that a dollar in income means more (yields more utility) to a poor man than to a rich man.<sup>4</sup> Or put the other way

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<sup>1</sup>See for example Theodore W. Schultz, "Capital Formation by Education," Journal of Political Economy, December 1950.

<sup>2</sup>"Why Does College Cost So Much?", Forbes, Vol. 17, No. 11, June 1, 1966.

<sup>3</sup>See for example Parts I and VI.

<sup>4</sup>The same concept applied to a particular individual implies that as a man's income increases, the utility added by each successive increment of income declines.





around, the concept states that a dollar loss in purchasing power causes a poor man to suffer a greater loss in utility than a rich man would suffer from the loss of the same amount of purchasing power.

These propositions cannot be verified in the real world, but observations of social action through the years should convince one that as a group we believe the propositions to be valid. From this has come the assumption that the ability to pay taxes is related in a positive progressive way to income. Nevertheless, there is little that can be said from a strict economic point of view about how progressive the tax system ought to be. One can say with a high degree of certainty, however, that the social consensus disapproves of regressive taxation in principle. But when one looks at the facts in the real world, the case for progressive taxation is not so strong as it appears to be in principle. Certain provisions in both federal and state income tax systems serve to nullify or dampen the progressivity specified by the rate structure.<sup>5</sup>

While the benefits received theory may have been appropriate for distributing tax burdens at one time, the benefits of public services in a modern society are so diffused that it is difficult if not impossible to isolate benefits received in any concrete fashion.

The relevance of the discussion above is as follows. The ability to pay principle is bound up in ethics and value judgments, and economic analysis cannot make much of a quantitative contribution to it. About the most we can say is that democratic social consensus opposes regressive taxation. And if, as suggested above, the benefits received principle is outmoded, as economists we have to look elsewhere for guides in distributing tax burdens.

It is obvious that the collection of taxes from the private sector of the economy has certain impacts that are undesirable from either the individual or the social point of view. This is true even though the spending of tax revenues on public services more than outweighs the private loss. The economic effects of tax collection may be categorized as (a) allocative, (b) distributive, (c) growth or (d) stability. An efficient allocation of resources, an equitable distribution of income, economic growth and economic stability seem to be prime objectives of economic policy.<sup>6</sup> A tax system should presumably be structured so as to minimize the ill effects on these goals. If a tax system changes the relative prices of goods and services, consumption patterns will be modified and resources will be allocated in a different manner than people would prefer. Taxes may also alter the pattern of income distribution in a way that is not consistent with the equity norms of society. Or taxes may hamper economic growth and introduce instability into the economic system by operating in a cyclical rather than a counter-cyclical manner. An "ideal" tax system would be designed in such a way as to minimize such ill effects.

There are three main criteria by which taxes may be levied among individuals or private economic units. Taxes may be levied according to what people own (assets), what people earn (income), or what people spend (consumption).

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<sup>5</sup>See Part VI of the Montana Tax Study

<sup>6</sup>Richard T. Bye, Social Economy and the Price System, and Kenneth E. Boulding, Principles of Economic Policy.



We can get pretty close agreement that people ought to pay taxes in relation to their economic well-being. At any point in time a person's economic well-being can be measured by the assets or wealth that he owns. This fact probably led to the historical popularity of the property tax for distributing the burden of paying for public services.

In principle, the assignment of burden on the basis of wealth or property is sound.<sup>7</sup> An asset (property) has value because it yields an income stream to its owner. As a matter of fact, the value of an asset is derived by discounting the income stream flowing from the asset. But physical assets (property) no longer serve as an appropriate index of wealth. In the modern world, a large part of a man's wealth is in the form of investment in himself as a productive human being.<sup>8</sup> So in a free society (a non-slave society), a large fraction of the wealth of the nation is not considered property. As a consequence, only a part of wealth or assets is subject to property taxation. The income tax of the 20th century represents a means of correcting such deficiencies in property or wealth taxation. Since wealth is not true wealth unless it yields an income stream, we use the stream itself (or income) as a proxy for wealth. This gets us around two problems. First, the income stream is discoverable and measurable even though the parent may be concealed. And second, we avoid the valuation (discounting) problem.

The third general criterion for levying taxes among individuals is spending or consumption. Consumption as an index of economic well-being is imperfect to say the least. As a practical matter it is not easy to determine whether a particular expenditure is for consumption or investment. The Department of Commerce makes such determinations in the national income accounts, but in many cases the distinction is admittedly arbitrary. Second, using consumption as an index of economic well-being carries the implicit assumption that consumption is the supreme objective of individual economic endeavor. Classical economic theory postulates that the goal of the individual (family) as an economic organism is to maximize the utility from a given income. This is often, if erroneously, taken to mean that the individual exhausts his income in pursuit of maximum utility through consumption. It must be true that both consumption and savings activities yield utility to the individual. Such elements as power, prestige and status are certainly products of savings-investment activity, as well as products of consumption activity.<sup>9</sup> In any event, a consumption activity tax at uniform rates results in a heavy burden on those with high propensities to consume relative to those with low propensities to consume. For these reasons it seems

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<sup>7</sup>Kenneth E. Boulding, Economic Analysis, 3rd Ed., Harper and Brothers, N. Y., p. 826.

<sup>8</sup>For most people, the income from capital invested in the person far outweighs other income. In 1965 about 71% of the national income consisted of wage and salary income.

<sup>9</sup>Veblen and Marx both throw some light on this subject, with Veblen emphasizing the consumption side and Marx emphasizing the savings-investment side.



obvious that consumption is not an appropriate measure of the relative economic well-being of individuals. Consumption taxes at uniform rates leave out part of the base or source of economic well-being and some individuals pay a higher tax relative to economic well-being than others. And since the propensity to consume in relation to income tends to decline as income rises, consumption taxes are always regressive with respect to income.

For the reasons discussed here, among others, the consensus of the Task Force is that the property tax as a source of state revenue should be abandoned. We feel that most statewide property tax levies should be phased out, and that property taxation be left almost exclusively to local governments. We recognize that property tax revenues will continue to be an important part of total Montana tax revenue, and that property tax collections will rise with economic growth. We are not, however, considering the property tax source as an alternative for meeting expanding revenue needs in the state of Montana.

The Task Force also takes the position that the state should rely on existing sources, particularly the personal income tax, for expanded revenue needs over the next few years. From the economic point of view, there is no need to compound the complexity of the Montana tax system by adding new sources. The State of Montana already has twenty-seven separate sources for revenue payable into the state treasury.<sup>10</sup> Within these sources are eight classes of property subject to ad valorem taxation, four categories of "gasoline" license taxes, three taxes in lieu of ad valorem taxes, thirteen categories of motor vehicle registration taxes, and seven categories of beer licenses and taxes. Including these variants, the state has forty-five sources of State Treasury revenue.

Many of the existing taxes are punitive and/or discriminatory.<sup>11</sup> Others are primarily regulatory in nature or merely serve as a means of expediting registry of certain property or activity.<sup>12</sup> Some of the license taxes amount

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<sup>10</sup>Twenty-First Biennial Report of the Montana State Board of Equalization,  
pp. 14-16.

<sup>11</sup>The chain Store License tax is a case in point. Most state taxes of this sort were intended to improve the competitive position of local merchants relative to "outsiders." Or put the other way around, the tax was intended to punish the chains for competing with local merchants. Obviously, the tax has now accomplished this objective. The trend toward multi-outlet firms continues unabated and the importance of the single store unit continues to decline.

<sup>12</sup>An example of the former is the Carbon Black License Tax. Examples of the latter are the Certificate of No. for Boats and the Gasoline Tax Refund Permit.





to either an unnecessary waste of administrative and compliance effort or they are patently discriminatory.<sup>13</sup> Many license tax and permit sources yield so little revenue that they are hardly worth the bother of administration and collection.<sup>14</sup> It certainly seems that the state should move away from such complexities in the tax system rather than add complexities to the system. A simple (as contrasted to a complex) tax system certainly makes it easier to achieve the accepted goals of tax structure. With the myriad of license taxes in the Montana system, it is virtually impossible to trace through the allocative, distributive, growth, and stability effects of the system. A complete tax revision study for the state system is in order.

As stated above, the Task Force feels that the state should rely primarily on changes in personal income tax provisions for additional revenue. We believe that the objectives specified earlier are easier to achieve in this manner.<sup>15</sup> We also believe that the personal income tax route is preferable on grounds of efficiency in administration and collection.<sup>16</sup>

We realize, however, that a general sales tax of some sort has been considered a practical and preferable alternative by many Montana citizens and by some legislators and public officials. The Task Force considers the general sales tax to be a second best alternative. Nevertheless, pragmatism demands that second best alternatives be considered.

The Task Force feels that it is possible to design a sales tax system that will make this alternative a much better "second best alternative" than most states have been able to achieve.

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<sup>13</sup>The Electric Energy Tax and the Telephone License Tax appear to be in this category. The firms concerned are subject to rate (price) regulation by the state, and these taxes are allowed as costs in rate-making procedure. Insofar as rates are formulized on costs, these taxes are borne by the patrons of the utility companies. But whether the tax is passed on to the patrons or borne by the companies, it is discriminatory.

<sup>14</sup>According to the 21st Biennial Report of the Montana State Board of Equalization, the following sources yielded these revenues in 1964: Telegraph License Tax, \$512; Aviation Gas Permit, \$710; Gasoline Dealers Permit, \$881; Cigarette License, \$1,745; Express Companies Tax, \$3,765; Vermiculite License Tax, \$7,812. These six sources totaled \$15,425 in 1964, and represented less than .02% of the "revenues payable into the state treasury."

<sup>15</sup>For a discussion of this point see Brownlee and Allen, Economics of Public Finance.

<sup>16</sup>For further discussion of these points see Part VI.



In the first place, we feel that a "general" sales tax should be limited to consumer goods and services.<sup>17</sup> If all consumer goods are taxed at a uniform rate the allocation of resources would be relatively undisturbed. The resulting change in prices would serve as a signal to the producing segment of the economy, and the resources freed from the production of consumer goods would be available to produce whatever government demands dictate. It is not necessary, as a matter of fact it is damaging, to compound the situation by levying sales taxes against producer goods. Sales levied on producer goods become costs to producing firms. The extent to which the tax affects the costs and the output of a firm depends on the importance of the taxed good in the production process. The result is that productive resources will be allocated in a manner different than consumer choice would dictate. It was mentioned earlier that the distinction between consumer goods and production goods is sometimes arbitrary.<sup>18</sup> While the definitions used by the Department of Commerce in the national income accounts are not perfect, they do serve as a specific base. The Department specifies about seventy-five categories of consumption expenditures.<sup>19</sup>

Many so-called "general sales tax" systems levy taxes against goods purchased "at retail." This may be a fairly close approximation to the consumer goods tax specified above. But there are important exceptions. For example, many producer goods used by farmers and ranchers are purchased from retail stores. Equity would require that all such items be exempt from sales taxation.<sup>20</sup>

As implied above, the Task Force also feels that a consumer goods tax without exemptions is superior to one that specified exemptions. There are several reasons for this position. First, a system with exemptions causes uneven changes in the price ratios between goods and a less desirable allocative pattern results. Second, there is always a clamor on the part of special interest groups to gain exemption. Third, exemption denudes the tax base. Fourth, exemption makes the tax harder to administer. Food and medical expenditures are often excluded from sales taxation, but these categories combined comprise about 36% of taxable consumption expenditures.<sup>21</sup> Another common exclusion is the category of services, as contrasted to commodities. Services accounted for about 40% of total consumption in 1964.<sup>22</sup> The exclusion of food, medical care, and services would reduce

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<sup>17</sup>Hereafter, the term "goods" will be used to denote goods and services.

<sup>18</sup>While a workman may consider his overalls to be a producer good, the Department of Commerce and the Internal Revenue Service considers them to be a consumer good.

<sup>19</sup>Survey of Current Business, Vol. 45, No. 11, November 1965, pp. 20-23. See Appendix Table 1 for estimates of the percentage that particular types of consumption are of total taxable consumption. See Footnote 2, Appendix Table 1 for the exclusions from total consumption.

<sup>20</sup>See Appendix A for an outline of a method for excluding producer goods and services.

<sup>21</sup>See Appendix Table 1.

<sup>22</sup>Survey of Current Business, Vol. 45, No. 11, November 1965, pp. 20-23.





the tax base by about three-fourths and require a rate four times as great as that needed to provide a given amount of revenue without the exclusions. Fifth, excluding certain goods from taxation involves judgments that are hard to defend. If medical expenditures are excluded, for example, the healthy and the fit are discriminated against. If food expenditures are excluded, the trim (those on diets) and people with small appetites are discriminated against. The other side of the coin, of course, is that obesity and gluttony are favored.

#### Montana's Revenue Needs

Nearly everyone assumes that each successive session of the Legislative Assembly will be faced with larger budgets than before. How fast will the budgets grow? How fast should appropriations be expanded to meet these requests. The answer to such questions depends basically on the rate of growth of the State economy and upon our willingness to divert resources (income) from private to public use.

In some areas of public service Montana is substandard. Since 1951, for example, State expenditure per capita for Public Welfare has declined at an annual rate of 38¢, while the average U. S. per capita expenditure has increased at an annual rate of 86¢.<sup>23</sup> Such comparisons are not strictly valid because Montana's welfare problem may not be comparable to that in other states, but the steady decline in Montana's per capita income relative to U. S. per capita income would seem to indicate that Montana is moving in the wrong direction.<sup>24</sup> Montana State Government expenditures per capita on Health and Hospitals averaged \$9.03 for 1951-65 compared to \$11.27 for the United States. Montana's annual rate of change in this expenditure was about 12¢ to 52¢ for the United States.<sup>25</sup>

Montana's Capital Outlay for correction institutions averaged 41¢ per capita for the period 1951-65, and declined at a rate of about a cent per capita during the period. Average U. S. expenditures for the same period were 38¢ per capita, but the U. S. expenditure increased at a rate of two cents per capita.<sup>26</sup> Montana's General Government Expenditures per capita, excluding highway expenditures, averaged \$72.51 for the 1951-65 period and increased at a rate of \$4.65 per year. The comparable figures for the United States were an average of \$49.67 and an annual increase of \$6.54. So while Montana per capita general expenditures exceeded the U. S. average for most of the 1951-65 period, Montana fell behind after 1962.

In another section of The Montana Tax Study, Dr. William Diehl projected Montana's revenue and expenditures through the fiscal year ending June 30, 1970.<sup>27</sup> The expenditure projections made by Dr. Diehl were not intended to reflect Montana's basic need for public services. Rather, they were intended to project the historical response of the legislature to budget requests during the 1951-65 period. In other words, Diehl's analysis did not deal with the question of how

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<sup>23</sup>See Appendix Table 2.

<sup>24</sup>See Part V of the Montana Tax Study for a discussion of Montana income in relation to U. S. income.

<sup>25</sup>See Appendix Table 2.

<sup>26</sup>See Appendix Table 3.

<sup>27</sup>Part V of the Montana Tax Study.



much revenue the state will require to meet the needs for public services. The "differences" presented by Diehl in Tables 41 and 42 merely reflect the expected budget positions if our future reaction to needs is the same as it was during 1951-65. Obviously, this is not the same thing as estimating the amount of revenue the state will require to meet the need for public services.

Diehl's projections for both revenue and expenditures were based on the relationship of Montana's per capita income to United States per capita income and upon alternative rates of growth in United States income per capita.<sup>28</sup> The expenditure projections make use of what statisticians call "linear regression." This procedure involves "arithmetic progression," as contrasted to "geometric progression," and the statistical results indicate that legislatures have tended to react in a linear fashion. This is not to say, however, that the states needs for public services change in a linear fashion through time.

There is some evidence that needs for public services change in a geometric fashion. If one looks to budget requests rather than appropriations as an index of needs, it appears that needs over the past few years have tended to follow the geometric route. Dr. Diehl has analyzed state expenditures for higher education and found that if appropriations for higher education continue to change in a linear fashion as they have in the past, expenditures per student will decline from now to 1971.<sup>29</sup>

The estimates that follow in this report are based on the assumption that Montana's needs for public services as reflected in expenditure requirements follow a geometric pattern up to 1971.

Projections similar to those in Part V have been made for state expenditure needs for the 1966-71 period. The estimating procedure is the same as that used in Part V, except that the data were put in log rhythmic form. The results of these projections for total expenditure needs by years appear in Appendix Table 6. The estimates for the biennia ending June 30, 1969 and 1971 are presented in Table 1 below, along with the total revenue projections.

The needs estimates are presented as "low," "median," and "high." These levels of estimate are tied to the alternative rates of growth posited for the United States economy. The "low" estimates are those that would be expected if U. S. per capita income were to grow at an annual rate of three percent; the "median" estimates conform to a four percent annual growth in U. S. per capita income; and the "high" estimates conform to a five percent growth rate.<sup>30</sup>

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<sup>28</sup>Ibid., pp. 2-5.

<sup>29</sup>See Appendix Table 4.

<sup>30</sup>See Part V, pp. 2-5.



TABLE 1

Estimates of Montana's Total Expenditure Needs and Projected  
Total Revenue for the Biennia Ending June 30, 1969 and 1971

Biennium Ending June 30th	Expenditure Needs <sup>1</sup>			Projected Revenue <sup>2</sup>			Difference Rev. Minus Exp.		
	Low	Median	High	Low	Median	High	Low	Median	High
	Mil.\$	Mil.\$	Mil.\$	Mil.\$	Mil.\$	Mil.\$	Mil.\$	Mil.\$	Mil.\$
1969	522.0	563.5	607.7	517.8	548.1	579.2	-4.2	-15.4	-28.5
1971	570.4	642.9	724.5	576.6	607.9	655.7	+6.2	-35.0	-68.8

<sup>1</sup>Data from Appendix Table 5

<sup>2</sup>Data for the 1969 biennium are from Table 41, Part V; data for the 1971 biennium consist of the 1970 figures from Tables 6, 9, 11, 13 and 15 in Part V and extrapolations for the year 1971. These projections include the University system levy and the state-wide two mill levy and do not conform with the figures in Table 4.

In Part V, Dr. Diehl suggested that his high revenue projection be set against his "low" expenditure projection for the purpose of viewing the prospective budget position at the end of the current biennium.<sup>31</sup> The reason for the suggestion is this: the annual growth rate in U. S. personal income has exceeded five percent during 1964-66.<sup>32</sup> So the revenue flow is greater than was anticipated prior to the beginning of the biennium. Appropriations for current expenditures, however, were made in early 1965 when the income growth rate for the three previous years had averaged about three percent.

Looking ahead to 1971 is another matter. The Viet Nam war and the economic forces associated with it should lead us to expect a U. S. income growth rate of at least five percent so long as these forces are present. If, as seems likely, the unsettled conditions in Southeast Asia continue for an extended period of time, it seems reasonable that we should base our state fiscal policy for the next two biennia on an assumed U. S. income growth rate of five percent or more.

This reasoning leads us to favor the "high" columns in Table 1. If U. S. per capita incomes continue to rise at a rate in excess of five percent as they have since 1964, the state of Montana should have total revenue of at least \$579.2 million in 1968-69 and \$655.7 million in 1970-71.<sup>33</sup> These are the revenues we should expect even with no significant changes in revenue sources or rates.

The procedure specified earlier for estimating expenditure needs yields "high" expenditures of \$607.7 million for the 1968-69 biennium and \$724.5 million for 1970-71. On this basis, the state would be short \$28.5 million in 1968-69

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<sup>31</sup>Ibid., p. 47.

<sup>32</sup>See Table 1, Part V. U. S. per capita income in 1964 was 5% above 1963; the figure for 1965 exceeded the 1964 figure by 5.8%; per capita income in 1966 is running ahead of 1965 by more than 6%.

<sup>33</sup>These revenue projections do not reflect the Task Force recommendation that the University System levy and the state-wide two mill levy be eliminated. See Footnote 1, Table 4, for these adjustments.





and \$68.8 million in 1970-71. This is an average shortage of \$14.25 million for fiscal years 1968 and 1969 and 34.4 million for fiscal years 1970 and 1971. It is important to keep in mind that these estimated shortages are minimal if, as seems likely at the present time, the U.S. income growth rate exceeds five percent over the next four years. A "median" growth rate of four percent would result in a revenue shortage of \$15.4 million for the 1967-69 biennium and \$35.0 million for 1969-71. The "low" growth rate of 3% has not been considered here because present circumstances and those anticipated in the near future indicate that such a rate between now and 1971 and has a low probability of occurrence.

The analysis used in this report indicates that the State will need to raise about \$127 million more revenue over the next two biennia than current sources and tax rates will provide.<sup>35</sup> Most of this will have to come through taxes, and either rate revisions or new sources will have to provide an average of about \$32 million per year over the next four years.

What are the alternatives? At the beginning of this paper, we discussed the general attributes of three alternatives. As stated earlier, the Task Force rejects the property tax as a practical alternative.<sup>36</sup> Between the remaining two, the personal income tax and a general sales tax, the Task Force has a rather strong preference for the personal income tax route. Nevertheless, we are presenting both the changes in the personal income tax and the sales tax rates that would be required to meet the estimated needs presented above.

The Task Force has made estimates of the revenue yields of certain changes in the provisions of the personal income tax law. These estimates were based on existing rates and on 1965 levels of personal income. In Table 2 below, these estimates have been expanded at an annual rate of five percent to obtain estimates for the years 1968 through 1971.<sup>37</sup>

TABLE 2  
Estimated Revenue Yield of Selected Changes in Montana's  
Personal Income Tax Provisions for Fiscal Years 1968-1971<sup>1</sup>

Fiscal Year	Eliminating All Deductions	Substituting \$6.60 Tax Credit for \$600 Exemption	Eliminating Separate Filing Provision	Total
	Mil.\$	Mil.\$	Mil.\$	Mil.\$
1968	18.8	12.2	4.6	35.6
1969	19.7	12.8	4.8	37.2
1970	20.7	13.4	5.0	39.1
1971	22.0	14.1	5.3	41.4

<sup>1</sup>These revenue estimates are based on the work done by Dr. John Wicks in connection with Part VI of The Montana Tax Study.

<sup>35</sup>This \$127 million figure is based on the elimination of state-wide property tax levies

<sup>36</sup>See pp. 7-9 of this report and Part X of The Montana Tax Study.

<sup>37</sup>See Diehl's income tax projections for 1966-70 in Table 7, p. 10, Part V. Diehl's projections change at an annual rate of almost six percent so the five percent rate used here appears to be on the conservative side.



Estimates of the yield of a "general sales tax" to the state of Montana are presented in Table 3. These estimates conform to the specifications set forth earlier in this paper that the Task Force feels would make the sales tax a better "second best alternative" than most other states have achieved.

TABLE 3

Estimated Yield of a Montana General Sales Tax on Consumption  
Goods and Services at Alternative Tax Rates for Fiscal Years 1968 to 1971

Fiscal Year	Estimated Yield in Millions of Dollars at Rate of: <sup>1</sup>				
	1.5%	2.0%	2.5%	3.0%	4.0%
1968	16.2	21.6	27.0	32.4	43.2
1969	16.6	22.2	27.7	33.3	44.4
1970	17.0	22.6	28.3	33.9	45.2
1971	17.3	23.0	38.8	34.5	46.0

<sup>1</sup>Estimates are based on data from Appendix Table 6.

The "high" revenue projections and estimated expenditure needs presented earlier are presented again in Table 4, along with the estimated shortage for fiscal years 1968 through 1971.

TABLE 4

Estimates of Montana's Total Expenditure Needs and  
Projected Total Revenue for Fiscal Years 1968 through 1971

Fiscal Year	Expenditure Needs	Revenue Projections <sup>1</sup>	Difference (Rev. minus Exp.)
	Mil. \$	Mil. \$	Mil. \$
1968	290.2	273.8	-16.4
1969	317.5	291.6	-25.9
1970	346.6	310.2	-36.4
1971	377.9	330.0	-47.9

<sup>1</sup>The revenue projections are adjusted to conform to the suggestion of the Task Force that the University System levy and the state-wide two mill levy be eliminated. The adjustments were as follows: 1968, \$6.7 mil.; 1969, \$7.1 mil.; 1970, \$7.5 mil.; 1971, \$8.0 mil.

The estimated revenue gap for fiscal year 1968 is \$16.4 million. This gap could be more than filled by: (1) the "tax credit" and filing provisions (Table 2); (2) by the "deduction elimination" provision (Table 2) or by a one and a half percent sales tax rate (Table 3).

The 1969 shortage of \$25.9 million could be met by: (1) the "elimination of all deductions" combined with the "tax credit" provision (Table 2); (2) by a two and a third percent sales tax (Table 3).





The estimated 1970 shortage of \$36.4 million would require all three income tax provisions in Table 2, or a sales tax rate of about three and a fourth percent.

The 1971 shortage of \$47.9 million would require all three of the income tax provisions in Table 2 plus a fifteen percent increase in income tax rates, or a sales tax rate of about four percent.



## APPENDIX TABLE I

Montana: Estimated Percentage Distribution  
Of Consumption Expenditures by Type of Consumption<sup>1</sup>

<u>CONSUMPTION CATEGORY</u>	<u>PERCENTAGE OF TOTAL CONSUMPTION<sup>2</sup></u>
I. Food and tobacco	30.76
1. Food for off-premise consumption	(22.43)
2. Purchased meals and beverages	( 5.87)
3. Tobacco products	( 2.46)
II. Clothing, accessories, and jewelry; includes shoes and other footwear; luggage; cleaning, repairing and storage of clothing, footwear, and furs; watches; watch and clock repair; clothing and dress rental; etc.	12.55
III. Personal care: includes toilet articles and preparations, barber shops, beauty parlors and baths	2.19
IV. Housing at hotels, motels, etc.	.57
V. Household operation: includes furniture; appliances; tableware and utensils; floor covering; cleaning supplies; textiles; stationery and writing supplies; household utilities (gas, electricity, water, telephone); etc.	18.22
VI. Medical care expenses, including health insurance	7.92
VII. Personal business: includes brokerage charges, bank charges; legal services; funeral expenses; etc.	4.09
VIII. Transportation; includes cars and accessories; tires, gasoline, and repairs; fares for trains, busses, airlines, and taxicabs	16.20
IX. Recreation: includes books and magazines; toys; radio and television sets and repair; theatres and other forms of amusement; sports events; etc.	7.50

<sup>1</sup> Based on data in U.S. Department of Commerce, Office of Business Economics Survey of Current Business (U.S. Government Printing Office, Washington, D.C.) Vol. 45, No. 11, November 1965.

<sup>2</sup> The following are excluded from "total" consumption: food furnished employees without charge, clothing furnished to military personnel, residential housing, services furnished without charge, private education and research, and religious and welfare activities.



APPENDIX TABLE 2

State Government Expenditures Per Capita By Function,  
Montana and Average United States, 1951 to 1965

	Montana			U.S.	
	Per Capita Expenditures			Per Capita Expenditures	
	Average 1951-65	Average Change Per Year <sup>1</sup>	Average 1951-65	Average Change Per Year <sup>1</sup>	
Total Insurance Trust	\$18.156	\$ .9592	\$17.524	\$ 1.2054	
Liquor Stores	21.388	-.2878	4.985	.0029	
Miscellaneous	8.495	.6286	12.452	.8945	
General Control	4.275	.2280	3.483	.1844	
Employment Security	2.149	.1242	1.641	.0970	
Natural Resources	11.005	.2642	4.830	.2215	
Health and Hospitals	9.027	.1180	11.271	.5167	
Highways	61.731	5.6700	36.301	2.2442	
Education	50.373	3.4218	44.942	3.6040	
Public Welfare	19.639	-.3842	19.542	.8637	
Public Safety	4.389	.2310	3.679	.1962	
Total General Expenditures	171.086	10.3016	138.412	8.7887	
Total Expenditure	211.963	11.7758	160.729	9.9975	

<sup>1</sup>Test of H; b=0, significant at 95% level.





## APPENDIX TABLE 3

Trends in State Government Capital Outlay Expenditures Per  
Capita By Selected Functions, Montana and the United States  
Average, 1951 to 1965<sup>1</sup>

<u>Function</u>	<u>Capital Outlay Per Capita</u> <sup>2</sup>			
	Montana		United States	
	<u>1951-65</u> <u>Average</u>	<u>Avg. Chg.</u> <u>Per Year</u>	<u>1951-65</u> <u>Average</u>	<u>Avg. Chg.</u> <u>Per Year</u>
All Education	\$7.04	+ \$ .37	\$4.08	+ \$ .42
Hospitals	1.15	- .15	1.32	- .04
Correction	.41	- .01	.38	+ .02
Public Buildings	.42	+ .02	.32	+ .03
Higher Education	6.17	+ .40	3.52	+ .38

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<sup>1</sup>Data from U.S. Department of Commerce, Bureau of the Census, Compendium for State Government Finance, (U.S. Government Printing Office: Washington, D.C.), 1951 to 1965.

<sup>2</sup>Includes expenditures for construction, equipment, land, and alterations for fixed structures.



## APPENDIX TABLE 4

Montana University System: Enrollment,  
Total Expenditures, and Expenditures Per Enrollee, 1955 to 1965  
and Projections for 1966 to 1971.

<u>Year</u>	<u>Total Expenditure<sup>1</sup> (Mil. Dollars)</u>	<u>Enrollment<sup>2</sup></u>	<u>Expendi- ture per Enrollee</u>
1955	8.3	8,902	\$ 932
1956	12.5	8,091	1,544
1957	13.5	8,054	1,677
1958	16.2	9,208	1,755
1959	16.9	10,115	1,672
1960	18.1	10,478	1,728
1961	22.2	11,806	1,883
1962	23.6	12,570	1,875
1963	21.7	13,324	1,630
1964	27.4	14,797	1,854
1965	29.8	16,882	1,766
1966*	30.7	18,183	1,686
1967*	32.6	19,705	1,652
1968*	34.9	21,226	1,645
1969*	36.9	22,747	1,623
1970*	39.3	24,270	1,620
1971*	41.3	25,769	1,603

<sup>1</sup> Source for 1955-65 data: Compendium of State Government Finances, Annual Issues 1955 to 1965.

<sup>2</sup> Source for 1955-65 data: Secretary, Montana University System.

\* Expenditure projections for 1966-71 are based on 1951-65 data; enrollment projections for 1966-71 are based on 1955-65 data.





APPENDIX TABLE 5

MONTANA: Total Expenditure Needs Estimates, Fiscal Years 1966 to 1971

Fiscal Year Ending June 30	Expenditure Estimates <sup>1</sup>		
	Low	Median	High
	Mil. \$	Mil. \$	Mil. \$
1966	233.4	238.5	246.7
1967	243.9	254.8	265.7
1968	255.1	272.3	290.2
1969	266.9	291.2	317.5
1970	279.0	310.8	346.6
1971	291.4	332.1	377.9

<sup>1</sup> Estimates are based on the equation,

$\text{Log } Y = -5.11960 + 2.25665 \text{ Log } X$ , where Y is expenditure per capita and X is per capita income.

$r^2 = .845$ ;  $t = 8.41$ .



## APPENDIX TABLE 6

MONTANA: Estimated Taxable Personal Consumption Expenditures 1950-64,  
with Projections for 1965-71. 1/

<u>Year</u>	<u>Taxable Consumption Expenditures (Millions of \$)</u>
1950	679
1951	706
1952	706
1953	717
1954	716
1955	721
1956	767
1957	808
1958	839
1959	898
1960	880
1961	893
1962	882
1963	1,017
1964	1,019
1965	1,009
1966	1,033
1967	1,058
1968	1,082
1969	1,106
1970	1,130
1971	1,154

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<sup>1/</sup> Estimates are based on consumption data in Survey of Current Business, November 1965, pp. 20-23. It is assumed that the ratio of consumption to personal income is the same for Montana as for the United States. Nonmarket consumption transactions and consumption payments in kind are excluded.



## Appendix 1

It was argued in the body of Part VIII that a "general sales tax" ought to be limited to consumer goods and services and that there ought to be no exemptions from the tax. Admittedly such specifications give rise to certain problems. The first specification requires that all producer goods and services purchased at retail be exempt from taxation. The second specification requires that all consumer goods and services be taxed even though certain goods and services may be vital to a minimum level of subsistence. The former results in administrative and collection problems, and the latter results in welfare problems.

It has been suggested that the usual "retail sales tax" might approximate the specified consumption tax. There are certain types of business firms, however, that purchase significant quantities of producer goods and services at retail. Chief among these are farmers and ranchers. Certain other "small businesses" also buy supplies from retail outlets. Particularly where a certain item is a consumption good to an individual and a producer good to a firm, the administrative and collection problem is complicated. It is suggested that all goods and services sold through retail outlets be taxed in the usual manner and that a tax credit under either the individual income tax or the corporation license tax be used to offset the sales tax paid. The test for eligibility of such expenditures for tax credit already exists. Producer goods and services qualify as business expenses in both the Federal and the State tax systems. Firms are now required to justify "business expenses" and any sales taxes paid in connection with such expenses would qualify as a tax credit. In some cases, where the firm and the household are not clearly segregated, certain expenditures would have to be divided between consumption and production. But such is already the case with income taxation.

The usual reason for excluding certain categories of goods and services from sales taxation is that "necessities," for example food and medicine, are required for sustenance. In an affluent society, categorizing such goods as "necessities" is neither very valid nor very meaningful. In most households a television set on the blink or a power failure will cause more distress than a closed grocery store. In any event it is income that is necessary, and if the objective is to provide subsistence at some minimum level of health and decency it is more appropriate and more practical to work on income directly. It is true that any kind of taxation is especially detrimental to the poor. Those at the "minimum level of health and decency" cannot afford sales taxes or any other kind of taxes. A sales tax system is especially hard on the poor because they spend a high proportion of their income on sustenance.

But the poor are not the only consumers of food, clothing, shelter, and medicine. Everyone else consumes these things too, and the well-to-do consume more of these things than do the poor.

A tax credit or rebate is superior to specific sales tax exemptions for relieving the plight of the poor.<sup>1</sup> The superiority is clear on either allocative or administrative grounds. Let's suppose that it is desirable to provide each person with \$600 per year in tax free income as both the Federal and the State personal income tax now suggest. Each member of a household would then be entitled to a tax credit equal to \$600 multiplied by the sales tax rate. As a two percent rate, the credit would amount to \$12 per person. A family of five, for example, would be allowed \$60 as an offset against any State income tax liability the family might have.

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<sup>1</sup>See Part IX, pp. 7, 11, and 14 of the Montana Tax Study.





## APPENDIX 2

### INHERITANCE TAXATION

by

John H. Wicks

We saw in Appendix 5 to Part Six that our present method of taxing inheritances produces little relationship between the income of the recipient and the tax rate he pays on an inheritance. The effective rate of our inheritance tax varies considerably among beneficiaries with similar incomes. Since one of the important arguments to justify the taxing of inheritances is that these bequests add to the economic ability of the recipients, this low degree of relationship between the tax and income--which provides a measure of a beneficiary's economic ability--tends to indicate that the present tax is unfair.

One method which would be a plausible way to correct this inequity would be to tax inheritance bequests as ordinary income of the recipients. With this type of taxation, the rate of tax depends on the beneficiary's income. Recipients with similar incomes would pay similar tax rates. Table 1, which is based on the sample of 1964 Montana inheritance tax returns described in Appendix 5 to Part Six, shows the percentage of tax which would apply on bequests to individuals in various income brackets if bequests were taxed as regular income, and the corresponding percentages which prevailed in 1964 under our existing tax. From the second and fourth columns of the table which list the coefficients of variation of these percentages, it is evident that the proposed tax based on beneficiaries' incomes would provide more uniform treatment of inheritances by people with similar incomes. Under the proposed method, the coefficients are roughly one-third as large as the coefficients with the existing inheritance tax. The proposed tax would be progressive at all levels of the income of recipients. It would have yielded about \$7.1 million in 1964, compared to the \$2.2 million which the existing tax yielded.

There are two drawbacks in taxing inheritances as regular income. First, some bequests may not add to the economic well-being of recipients (for example, moderate bequests by husbands and fathers to widows and young children.) The proposed method nevertheless includes all bequests. Secondly, treatment of bequests as taxable income will usually cause considerable fluctuation in a taxpayer's income, because inheritances are likely to be received only once or twice in a person's lifetime. We have seen that with progressive income tax rates, fluctuations in a person's income will tend to raise his tax liability over what it would be if he had received the same total amount of income steadily over the years. Such an increase in tax liabilities tends to discriminate against income from inheritances.

A method of circumventing these two shortcomings would be to allow an amount of bequest to members of the family (for example, spouses and children) to be tax-free and to tax the balance of the bequests at a flat rate which varies with the income of the recipient. An example would be to allow the present inheritance tax exemptions of \$20,000 for wives, \$10,000 for husbands, and \$2,000 for children and to tax the remainder of bequests to these classes of recipients and all other bequests at the marginal income tax rate which applies to the taxpayer in the year



TABLE 1

TAX LIABILITY AS A PERCENTAGE OF BEQUEST SIZE WHEN INHERITANCES ARE  
TAXED UNDER TWO METHODS OF TAXING INHERITANCES\*

Federal Adjusted Gross Income of Beneficiary	Existing Inheritance Tax		Taxation of Bequests as Income of the Beneficiary	
	Average Tax ÷ Bequest	Coefficient of Variation	Average Tax ÷ Bequest	Coefficient of Variation
0 - \$2,000	1.66%	100.8%	4.12%	43.2%
\$2,000 - 4,000	2.08	102.3	4.60	34.0
\$4,000 - 6,000	1.74	108.3	4.93	32.1
\$6,000 - 10,000	1.93	101.7	5.27	29.7
\$10,000 - 15,000	2.03	85.5	6.38	13.0
\$15,000 and above	3.30	73.1	6.54	16.6

\*Figures based on data from sample of 1964 Montana inheritance tax returns.

he receives the bequest. (If the tax rate is four percent on taxable income between \$3,000 and \$5,000, the marginal tax rate would be four percent for a person with total taxable income between \$3,000 and \$5,000.) In 1964 when income tax rates ranged between one and seven percent, taxation of bequests by this method would have yielded about \$2.9 million, or about \$700,000 more than the existing method.

The exemptions in this second alternative method would make an allowance for bequests not likely to increase the well-being of recipients, and applying a constant rate to the total amount of the bequest which is taxable would avoid the problem of inheritances causing income fluctuations. The tax rate on the amount of the inheritance less any exemption would be absolutely identical for all beneficiaries in a given income bracket. If we accept the premise that income provides a good measure of a taxpayer's economic ability, then we may conclude that this alternative method of taxation is closely based on economic ability.

In the event that such an alternative method of taxing inheritances were to be adopted, it would probably be desirable to base the tax rate on the taxpayer's average income over the past three, four, or five years to avoid the possibility that the taxpayer's income the year he received the bequest was abnormally high or low. And a person with a low average income to determine his tax rate on a bequest could be made wealthy if the bequest was very large.



## Appendix 3

### INDIVIDUAL INCOME TAX

by

John H. Wicks

Of all the existing Montana taxes, the personal income tax probably offers the most varied opportunities for change which will yield additional revenues. The reason for these opportunities is the complex nature of the tax. The types of change which are possible fall into three categories: changes in the tax base, alterations of the rate structure, and stating the tax as a percentage of the federal income tax liability. These possible changes are discussed in the following sections. Much of the data on which this discussion is based comes from the income tax study reported in Appendix 4 of Part VI.

#### Tax Base Changes

##### Items Included in the Definition of Income

Alteration of our income tax base could be accomplished by changing the definition of income, exemptions, or deductions. It would, of course, be conceivable to alter the items included in taxable income in a great many ways. However, equity, administrative, and legal considerations curtail the number of feasible alternatives. Some items which are presently excluded from taxable income (for example, business expenses) are not economically defined as income. It would be unfair to tax such items, and adverse economic effects would result.

There are a number of items which are economically defined as income but are not taxed. Some of these items (for example, the return from do-it-yourself projects and owner-occupied homes) are excluded from taxable income for administrative reasons and some (capital gains and bequests) are excluded for other reasons.

Montana relies heavily on Federal Internal Revenue Service auditing and the threat of such auditing to provide accuracy in the amount of income reported for Montana income tax purposes. Thus, for Montana to attempt to tax income items which the federal tax excludes would involve not only the difficulties which led to federal exclusion, but also the necessity of Montana's adopting its own system of extensive auditing. A similar administrative problem exists when Montana taxes items which the federal tax excludes for other reasons and which need not be listed on the federal return. (An example is interest on state and local bonds, which Montana currently taxes.)

##### Returns from Owner-Occupied Houses

Although it would be virtually impossible to tax such things as the returns from do-it-yourself projects and from the returns from durable goods such as lawn mowers and television sets, taxing the net returns from owner-occupied homes is not completely out of the question from an administrative viewpoint.

Homes are all identified for property tax purposes. Taxing the returns from homes would involve multiplying the value of a home by some rate of return--say five or six percent--subtracting the interest the owner paid on any mortgage, and adding the remainder to taxable income. Homes are already appraised





for property tax purposes. Inclusion of the net return from owner-occupied homes in the tax base would yield roughly \$2.5 million in tax revenue.

Inclusion of this return on homes in the tax base would eliminate the inequity of the present exclusion which favors owners over renters, and owners of expensive homes over owners of modest ones. However, people who have devoted a large portion of their wealth to owning an expensive home already pay a significant amount of property tax, while people who own only modest homes and bought stocks and bonds with the remainder of their wealth probably escape property taxation on their stocks and bonds. The burden of taxing the return from homes would probably be slightly regressive. The current exclusion of this return probably tends to encourage the purchase of homes, and results in misallocation of productive resources. Taxation of the returns would eliminate the reallocation.

### Capital Gains

The portion of income from capital gains which is not subject to taxation is an exclusion which could be eliminated without administrative difficulty.

Only half of the net amount of capital gains income in excess of certain capital losses is subject to taxation. The items making up this taxable amount must now be itemized on a schedule attached to a taxpayer's Montana individual income tax return. Therefore, to tax the full net amount rather than only half of it would require only the multiplying of the net amount by two and including the product in the tax base.

On the basis of the study described in Appendix 4 of Part VI, taxation of all capital gains income would yield about \$848,000 per year in additional revenue, assuming that 1965 levels of income prevail. If personal income continues to rise, the amount would be greater. Since capital gains comprise a much larger portion of the income of taxpayers with large income than of those with moderate or low earnings, the taxation of all capital gains would increase the progressivity of the tax.

Probably more important from the view point of tax fairness is the fact that the existing treatment of capital gains favors some taxpayers much more than others, because the gains vary widely from taxpayer to taxpayer within an income bracket. These variations do not represent economic ability differences. Consequently, taxing all gains would eliminate the favoritism given to certain taxpayers and increase tax equity.

As discussed in Part VI, capital gains tend to fluctuate from year to year. Progressive income tax rates discriminate against fluctuating incomes. It may be argued that taxing capital gains as ordinary income would discriminate against earners of this income because of the heavier tax burden on fluctuating incomes. Nevertheless, the progressivity of our income tax rate ends at \$7,000, and most people with large amounts of capital gains have more than \$7,000 in taxable income. To avoid any discrimination against capital gains earned by people with less than \$7,000 in taxable income, the gain could be taxed at the marginal tax rate applying to the taxpayer's income net of the gain.

Such a provision would add somewhat to the bother of preparing a tax return and thus to the compliance cost of the tax. However, the addition to administrative and compliance costs of taxing total capital gains should be negligible, because the only change involved is the taxing of all rather than half



of net long term capital gains. The economic effects of the change would also be small. Capital investment by Montanans might go down slightly.

#### Income from Governmental Retirement Programs

The income from other federal, state and local retirement programs are excluded, but the total retirement income excluded may not exceed the amount of the maximum social security payment.<sup>1</sup> Payments from social security and most of the other retirement programs involved consist of four parts: a return of the amount contributed by the recipient, interest on the accumulated contributions of the recipient, employer's contributions, and interest on the employer's contributions. The first item is not included in the economic definition of income, but the last three are.

Inclusion of these last three items in the tax base would eliminate the favoritism toward those who happen to receive retirement income from the government. Because of tax progressivity, this favoritism is worth more to middle (or high) income taxpayers than to those with low incomes, although most recipients of such payments are likely to have rather low total income.

However, it is not possible accurately to distinguish between the first and second components of retirement income accurately, because the division depends on how long the recipient is going to live. One way to avoid this problem would be to tax the portion of retirement payment which corresponds to the employer's contributed share. Data are not available to estimate the revenue which would be gained by eliminating the government retirement income exclusion. Because of the lack of these data on present income tax returns, administration of inclusion of retirement income might be difficult.

#### Changes in Deductions

The impact of income tax deductions on the fairness, economic effects, and compliance costs are discussed in detail in Part VI and Appendix 4 to that part. Some items allowed as deductions--such as medical expenses for example-- probably reduce the economic ability of taxpayers. Others, however, like interest paid, contributions, and federal and other taxes paid are simply uses of funds which represent taxpayer ability or normal expenditures. Allowing such deductions discriminates in favor of those people with greater than average amounts of them, and tends to encourage making of the type of outlays involved and has some effect on resource allocation. The following paragraphs consider the elimination of various deductions.

#### Total Deductions

If the 1965 level of personal income continues, elimination of all deductions would yield about \$16,250,000 in added yearly revenue with present tax rates. This would be an increase in revenue from the tax of about 75 percent. Elimination of deductions would increase the average progressivity of the tax, because total deductions as a percentage of income increase as taxpayers' incomes rise. The change would increase the uniformity of tax liabilities among people with similar incomes. Abolishing deductions would terminate the resource

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Federal law prohibits taxation of social security payments, so these payments are not possible objects of additional state tax revenue.





reallocation that has arisen from various deductions and would ease administrative and compliance problems. One currently important area of income tax administration is the verification of deductions reported, especially for married taxpayers who file joint returns. Deductions also are one of the biggest compliance problems for individuals in keeping tax records and in preparing their returns.

### Specific Deductions

The estimated amount of revenue which would be gained by eliminating various particular deductions is shown in Table 1. These estimates are based on 1965 levels of personal income and thus understate future collections. The reader may note that the largest gain in revenues would result from eliminating the deductibility of federal income tax paid. The fairness and effects on economic behavior of each of these deductions are discussed in Part VI.

TABLE 1

#### ESTIMATED YEARLY REVENUE GAIN FROM ELIMINATING VARIOUS MONTANA INDIVIDUAL INCOME TAX DEDUCTIONS ASSUMING 1965 INCOME LEVEL

Deduction	Revenue Gain	Percent of 1965 Income Tax Collections
Medical expenses	\$ 910,000	4.3%
Contributions	1,120,000	5.2
Interest paid	1,660,000	7.8
Federal income tax	6,520,000	30.5
Other taxes	1,420,000	6.6

Elimination of the deduction for medical expenses would have a regressive impact and might discourage medical expenditures. Contributions are made voluntarily, and may be considered as representative of taxpayer ability-to-pay. If they were not deductible, discrimination in favor of those making them would be eliminated, and the tax would be made more progressive. Contributions would tend to be discouraged, and there would be a reduction in the quasi-governmental services provided by some of them. A reduction in contributions which do not result in quasi-governmental services (such as contributions to educational institutions) would probably improve resource allocation from an economic viewpoint. Discontinuance of the deduction of interest paid would end the favoritism now given to those who choose to pay interest for the privilege of present rather than future consumption and would terminate the artificial encouragement given to borrowing by the present deductibility. The elimination of interest deductibility would increase progressivity on incomes up to about \$7,500. Most other taxes paid are supposedly measures of economic ability, so it can be argued that ending their deductibility would make the income tax conform more closely to economic ability. Making the federal income tax or all taxes nondeductible would make the tax more progressive on incomes above about \$20,000 but would not significantly affect progressivity on incomes of less than that amount.

Elimination of each of the deductions mentioned above would increase the uniformity of the tax burden for people with similar incomes. There would be





no addition to administrative or compliance costs for any of these proposed changes, because all that would be involved is the elimination of one or more subtractions from taxable income. In fact, as we noted in connection with the abolition of all deductions, costs would probably be eliminated in many instances. The federal income tax deduction is one of the specific factors adding to the administrative costs of the State Board of Equalization, and deductions are the cause of much record-keeping by taxpayers.

#### The Standard Deduction

At present a taxpayer may exclude ten percent of his adjusted gross income from taxable income, in lieu of itemizing deductions, subject to a maximum of \$500 for an individual taxpayer and \$1,000 for a married couple filing jointly. However, mainly because of federal income tax deductibility, it pays most taxpayers to itemize deductions on their Montana return, even if they do not itemize deductions on their federal return. This itemization probably makes for significant increases in both compliance and administrative costs. One solution to this compliance and administrative problem would be the elimination of federal income tax deductibility. If we continue to allow all of the deductions now permitted, Board of Equalization personnel estimate that it would require a standard deduction of 20 percent subject to a maximum of at least \$1,000 for single taxpayers and \$2,000 for married couples to reduce these costs for a sizable number of returns. Such a doubling of the size of the standard deductions would cost roughly \$1.1 million in tax revenue. This change would tend to reduce the income redistribution--that is, taxpayers with similar incomes would pay more nearly equal percentages of their income in tax--and economic behavior changes resulting from deductions would also be lowered.

An alternative method of reducing the administrative and compliance costs inherent in itemizing deductions would be to allow deductions only to the extent that their total exceed some percentage of the taxpayer's adjusted gross income. Instead of causing a revenue loss, this change would produce additional yearly revenue of approximately \$9.5 million. The effects on income distribution and economic behavior would be of the same type as for the doubling of the standard deduction.

#### Personal Exemptions

The present exemption from taxable income of \$600 for the taxpayer and for each of his eligible dependents has the apparent purpose of allowing a minimum amount of income tax-free. The rationale of this provision is that the amount of income necessary for subsistence (assumed to be \$600 by our tax law) does not represent ability to pay taxes.

Our present exemption provision discriminates in favor of taxpayers with high incomes, for \$600 of tax-free income is worth more to a person with considerable income than to a low income person. (For example, a \$600 exemption saves \$47.40 in taxes--\$600 times 7.9 percent--for a person with taxable income in excess of \$7,000, but it saves only \$6.60--\$600 times 1.1 percent--when a person's taxable income is less than \$1,000.) A way to eliminate this discrimination would be to allow a credit of \$6.60 per dependent against the tax liability of each taxpayer. For example, a taxpayer with a wife and two dependents would be allowed to deduct \$26.40 from his tax liability regardless of the level of his income.



In effect, this credit would give tax-exempt status to the first \$600 rather than the last \$600 of a person's income. Its substitution for exemptions would yield additional tax revenue of about \$10.5 million per year; that is, tax revenue would be increased by 50 percent. If this credit provision were enacted after the elimination of all deductions, the revenue gain would be about \$12.7 million rather than \$10.5 million. The larger revenue gain would be due to the fact that elimination of the deductions would have placed some taxpayers in higher marginal rate brackets. This change would increase the progressivity of the tax. The impact of the tax credit on administration and compliance would be similar to the present exemption procedure.

### Rate Structure

The current rate structure of the Montana income tax is discussed in Part VI. These rates include an increase of about ten percent for the 1965-1967 biennium which was passed by the 1965 legislature. This ten percent increase yields about \$2.1 million per year. Its elimination would, of course, reduce revenues by that amount (and would lower by about ten percent most of our revenue estimates resulting from other possible changes in the tax). A percentage increase or decrease of this type will have virtually no effect on the distribution of the tax burden and will only tend to magnify or diminish the effects of the tax on economic behavior. Neither administrative nor compliance costs are likely to be affected unless a lower tax makes strict administration or avoidance less worthwhile, and vice versa.

### Flat Percentage Increases

Thus, we may conclude that any flat increase in rates of a given percentage (for example, ten percent) will increase total tax revenue by almost exactly the percentage increase. For instance, each ten percent increase over the present rates will yield about \$2.1 million in additional revenue. Any such increase would be more or less neutral with respect to burden distribution patterns, economic effects and administrative and compliance costs. A percentage increase of this type made in conjunction with any of the any other ways we have considered to raise additional revenue would cause a commensurate increase in our estimates of the revenue yields from these other changes. For instance, an across-the-board increase in rates would make the revenue from the substitution of the \$6.60 tax credit for the \$600 personal exemption be about \$11.5 million rather than \$10.5 million.

The reader must be careful to note the difference between a percentage increase as discussed above and an increase of the percentage points in the tax rate. The former type of increase multiplies each tax rate by a given percentage and adds the products to the respective original rates. (For example, if the original rates were one and two percent, the rates after a ten percent increase would be 1.1 and 2.2 percent.) The latter type of increase adds the same number of percentage points to each original rate. (In our example, an increase of one percentage point in the original rates of one and two percent would result in new rates of two and three percent.) In the following paragraph we discuss the latter type of increase.





### Percentage Point Increases

An increase of one percentage point in the tax rates in each income bracket, which would make the range in rates be from 2.1 to 8.9 percent, would yield approximately \$6.4 million per year. A two percentage point increase would bring in about \$12.8 million, and so forth. Increases of this type will decrease the progressivity of the tax, because the percentage increase in the tax rate is greater for low than for high tax brackets. This type of change will have no effect on the tax liability as a percentage of income of taxpayers with similar incomes, and it is unlikely to have any material effects on economic behavior except to add to the degree of the existing effects. There should be no effects on administrative and compliance costs, unless the higher tax rates should make greater administrative or tax avoidance effort profitable. Each increase of one percentage point in every tax bracket would increase the estimated revenue gain from most of the other changes we have considered by roughly 30 percent. But it would not change any of the inequities inherent in our income tax structure--except to underscore them.

### Greater Rate Progressivity

At the present time the progressivity of the rates structure of our state income tax ends at \$7,000 of taxable income.<sup>2</sup> An example of more progressive rates on higher incomes would be ten percent on taxable income between \$10,000 and \$15,000 and twelve percent on incomes in excess of \$15,000. (The current rate on these income levels is 7.9 percent.) Eleven of the 35 states taxing individual income levy rates exceeding 7.9 percent. Imposing higher rates on incomes significantly in excess of \$7,000 would of course increase tax progressivity, but it would not affect variances in total tax liability as a percentage of income among taxpayers with similar incomes. Few effects on economic behavior would be likely. There would be no new administrative and compliance costs unless the higher rates made greater collection or avoidance efforts desirable. These increases would yield about \$700,000. We may conclude that tax rate increases in upper income brackets are not a feasible method for raising substantial additional revenue.

### Income Splitting by Married Taxpayers

As we have previously mentioned, the federal income tax law allows married couples to file a joint income tax return and to use tax brackets twice as wide as those applying to single taxpayers. (For example, a married couple filing jointly pays 14 percent on the first \$2,000 of taxable income, whereas the single taxpayer pays that rate only on the first \$1,000 and a higher rate on the second \$1,000.) Montana allows no such income splitting for married couples. The lack of such a splitting provision creates compliance and administrative problems. When both husband and wife have

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<sup>2</sup> The first \$1,000 of taxable income is taxed at 1.1 percent; the second \$1,000 at 2.2 percent; the third \$1,000 at 3.3 percent; the fourth and fifth at 4.5 percent; the sixth and seventh at 5.6 percent. All taxable income in excess of \$7,000 is taxed at a rate of 7.9 percent.



income, they must file two returns rather than one to minimize their tax. The apportionment of deductions becomes a subjective problem.

However, there would be some difficulties as well as benefits if we were to allow such income splitting. Although data are not currently available to measure accurately the revenue reduction which would occur, a loss of several million dollars would be likely. And the change would strongly discriminate in favor of married taxpayers, for the tax on them would be only half as progressive as the tax on single persons.

#### Levying a Flat Percentage of a Taxpayer's Federal Income Tax Liability

A quite different type of change which would materially simplify our state income tax would be to set the Montana tax liability as a flat percentage of a taxpayer's federal income tax liability. Each one percent levied against all taxpayers' federal income tax liabilities would yield about \$1.5 million yearly. Consequently, a tax of approximately 14 percent of a taxpayer's federal income tax liability would be necessary to raise the amount of revenue the Montana income tax presently yields. Although it would be simple to administer, tying our tax to the federal tax in this way would necessitate changing our tax rate every time the federal tax was changed if we wished to avoid uncontrolled revenue fluctuations. And we would automatically be saddled with the disadvantages of present federal tax provisions.

#### Summary

We have seen in this section that there are a number of feasible changes which would have major effects on Montana's income tax. Many would yield considerable revenue. Several of the changes which would produce the most additional revenues would leave the present rate structure unchanged. Substituting a tax credit equal to the bottom tax rate times \$600 for each dependent, in place of the \$600 personal exemption would yield about \$10.5 million per year. Allowing deductions only to the extent that they exceed twenty percent of adjusted gross income would raise approximately \$9.5 million and would materially lower administrative and compliance problems. Eliminating the deductibility of federal income taxes paid would add about \$6.5 million in revenues. The first and third of these proposals would be progressive, and the second would reduce tax progressivity. All would reduce the variability of tax liability among taxpayers with similar incomes and would be administratively feasible. The second would tend to reduce some adverse economic effects of the present tax.

Each ten percent increase in rates would yield about \$2.1 million in new revenues and would leave the distributional and allocative aspects of the tax about the same as the present. About \$6.4 million would be yielded by each one percentage point added to the tax rate in all brackets. This change would reduce progressivity, but probably have only minor allocative effects.





Gaylord

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